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State of Vermont
Public Service Board

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MAY 29 1998

Via Hand Delivery

May 29, 1998

Ms. Magalie Salas
Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Re: In the Matter of Federal-State Joint Board on Universal Service
CC Docket No. 96-45/CC Docket No. 97-160 and DA 98-715

Dear Secretary Salas:

Enclosed please find an original and five copies of the Reply Comments on Proposals to Revise the Methodology for Determining Universal Service Support for filing in the above-referenced proceeding.

Also enclosed is an extra copy which I ask that you stamp as filed and return to the messenger.

Sincerely,

Peter M. Bluhm
Policy Director

cc: Chairman Kennard
Commissioner Ness
Commissioner Furchgott-Roth
Commissioner Powell
Commissioner Tristani
Paul Gallant
James Casserly
Thomas Power
Kevin Martin
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Federal-State Joint Board on Universal Service	))))	CC Dockets No. 96-45 and 97-160, and DA 98-715

REPLY COMMENTS ON PROPOSALS TO REVISE THE METHODOLOGY FOR DETERMINING UNIVERSAL SERVICE SUPPORT

Summary

The Maine Public Utilities Commission and the Vermont Public Service Board conclude, based on comments received to date, that none of the objections voiced to the Ad Hoc Plan provides a reason to reject the plan. Contrary to the comments of some other parties:

1. The Act does not require that federal support be calculated by a model that separately calculates the cost of providing universal service in every census block group or wire center.

2. The Act does not require the Commission to make explicit every alleged "implicit subsidy" in state rates or in access charges.

3. The Commission has a legitimate interest in reforming interstate access charges, but this is not a universal service problem.

4. At least some increase in the amount of federal support is required by the Act.

5. States must inevitably play a major role in protecting universal service, and defining federal support by average state costs is a reasonable application of section 254.

6. The Ad Hoc Plan is fair to states with very high cost areas.

7. The Ad Hoc Plan is fair to small companies.

8. The 25-75 split of high cost responsibility is not sufficient.

9. Raising the benchmark is not sufficient.

10. Forward-looking costs and embedded costs should both be used in calculating support.

11. It is appropriate to use cost rather than revenue benchmarks.

12. The Ad Hoc Plan is competitively neutral, and is compatible with competition.

13. State distribution of federal funds does not undermine the Act.

The Ad Hoc Plan remains the only model that complies with the Act and has the support of state commissions in both high cost and low cost areas. The Commission should move forward with its review of the Ad Hoc Plan and implement that plan or one similar to it by the end of this year.

REPLY COMMENTS

The following reply comments are filed by the Maine Public Utilities Commission and the Vermont Public Service Board in response to DA 98-715.

I. THE ACT DOES NOT REQUIRE THAT FEDERAL SUPPORT BE CALCULATED BY A MODEL THAT SEPARATELY CALCULATES THE COST OF PROVIDING UNIVERSAL SERVICE IN EVERY CENSUS BLOCK GROUP OR WIRE CENTER.

Commenters US West and California argue that the Ad Hoc Plan fails to provide funding to areas that need it most. They define areas that need support as Census Block Groups (CBGs) with the highest cost. A similar argument is made by the Texas PUC.

The proxy models calculate support by calculating the difference between the modeled cost in each CBG (or exchange) and a national benchmark of $31 for residential lines and $51 for business lines. The difference between the cost and this benchmark is the presumed need for federal support. A major portion of this amount, however, exists today as implicit transfers within each carrier's study area. These transfers can occur between services, such as business and residential service, or from low-cost areas to high-cost areas.

The above commenters incorrectly presume that the Telecommunications Act of 1996 requires the Commission immediately to replace, with explicit federal support, all implicit transfers and allocations that today are found within state rate designs. For at least three reasons the Commission should reject this conclusion. Most obvious is the fact that such a fund would be enormous -- on the order of $8 billion -- a size that virtually all parties agree is politically unsustainable.

Second, there is no immediate need to establish such a large federal program. Even though local competition has begun, states are addressing implicit transfers within their rate designs in different ways. Some are proceeding quickly to identify transfers and replace them with state high cost funds. Other states are proceeding more cautiously, attempting to address such transfers incrementally and in a manner that is coordinated with their pricing of UNEs.

Even if the Commission were willing to create an $8 billion fund, it should refrain from spending that much until states are able to assess the implications on state retail rate designs and on their UNE pricing policies.[1]

Third, it is not entirely clear that the forward-looking cost models accurately predict prices in a competitive market. It is not certain that carriers will actually establish prices at the CBG or wire center level. They might choose a smaller scale, for example by imposing a surcharge on individual customers with long loops. Or, they might establish prices on a broader scale, such as a mass media market. In either case, the proxy models' estimates of what is an "implicit subsidy," because they are based upon group averages over small geographic areas, would be dramatically incorrect.

It would be premature to establish federal support based on the unproven assumption that competitive prices will vary from one CBG to another in a manner that maps exactly onto the cost outputs of the proxy models. Before taking such a step, the Commission should wait until it and state commissions have gained more experience with:

(1) whether the proxy models accurately predict cost;
(2) whether pricing in a competitive local exchange market operates as the proxy models assume; and
(3) how pricing behavior affects universal service.

II. THE ACT DOES NOT REQUIRE THE COMMISSION TO MAKE EXPLICIT EVERY ALLEGED "IMPLICIT SUBSIDY" IN STATE RATES OR IN ACCESS CHARGES.

We agree with the comments of the California PUC that the 1996 Act does not require that every alleged implicit subsidy should be replaced with a new explicit one. The Act recognizes that, because of competition, any subsidies that are now in rates will be increasingly difficult to maintain. Section 254 gives to the Commission and to state commissions the tools to respond to

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1. We note that AT&T has now adopted the view that there is no theoretical justification for calculating federal support at the wire center level. AT&T recognizes that support should not be calculated at a smaller geographic scale than a state commission sets the prices for unbundled network elements. AT&T correctly notes that a majority of states have established a single, statewide rate for UNEs.

this erosion of implicit subsidies.

Nothing in the Act requires the Commission to ferret out alleged subsidies, in the state jurisdiction or in the interstate jurisdiction, and replace them with explicit payments funded through Section 254. Given the practical limits on the amount of federal support, the Commission should give priority to the Act's express universal service goals of affordable and reasonably comparable rates. The Commission cannot and should not use universal service as a tool to accelerate competition by forcing states to eliminate whatever the Commission might consider to be "implicit subsidies."

The Ohio commission complains that the Ad Hoc Plan is vague concerning the extent to which federal support will address the removal of the implicit subsidies for all local carriers. The Ad Hoc Plan is clear. The Commission's proper responsibility under Section 254(a) and (b) is to bring the states to the same starting point. Thereafter, it is primarily a state responsibility to decide whether and to what extent rate rebalancing occurs within the state jurisdiction, and it is primarily a state responsibility to decide when to replace implicit subsidies in rates with explicit subsidies. The Commission should, of course, ensure that any federal support is distributed in ways that are consistent with the Act.

III. THE COMMISSION HAS A LEGITIMATE INTEREST IN REFORMING INTERSTATE ACCESS CHARGES, BUT THIS IS NOT A UNIVERSAL SERVICE PROBLEM.

Commenters such as Bell South, GTE and Sprint criticize the Ad Hoc Plan because it does not deal with alleged implicit subsidies in interstate access charges. The Ad Hoc Plan does not address those issues because Section 254 is not concerned with interstate access reform but with local rates.

Nevertheless, the Commission is properly concerned about reform of access charges. Because a portion of loop, switching and trunking cost is allocated to the interstate jurisdiction, recovery of those costs legitimately presents the question of who should pay those costs, and in what manner.

Some of the commenters seem to assume that it is the Commission's task to identify and eliminate all "implicit subsidies." The commenters do not provide an adequate legal basis for this assertion, nor an adequate definition of a "subsidy." It is not a subsidy to require a customer to pay all costs incurred by his or her carrier, even if those costs are considerably above the national average. For example, if a customer pays for all of the interstate cost of his or her loop, through a direct SLC payment and through the pass-through of a PICC, there is no implicit subsidy to that customer.

The thrust of GTE's comments is more about rate design than about subsidies. GTE appears concerned not so much that one customer is improperly subsidizing another, but that all customers should have low usage charges, and that joint and common costs should be recovered in some way other than through access charges. Thus the access reform proposals by GTE and Bell South do not appear to require any new federal funding. They remove certain costs from interstate access rates and collect those same costs through a percentage surcharge on interstate revenues.

The Commission has previously decided to recover joint and common costs through SLC and PICC charges. If the Commission were now to decide that some of these interstate joint and common costs (or other access costs above a certain level) should be recovered by a surcharge on interstate revenues, that would be a legitimate rate design decision by the Commission. Indeed, such a change in rate structure has merit since it may price access at levels closer to incremental economic cost.

As recognized by the California PUC, however, such a change would not have anything to do with universal service. In redesigning access charges, the Commission would not be using authority granted by Section 254. Moreover, whether such a redesign occurs or not, universal service is not likely to be jeopardized. If the Commission continues to collect joint and common costs through access charges, that may place some carriers at a competitive disadvantage, but it is unlikely to cause any customers to abandon telephone service.

There is no inconsistency between the Ad Hoc Plan and the access restructure proposed by Bell South and GTE. The Commission should be clear, however, that the surcharge they propose on revenues is not a universal service charge but an element of interstate cost recovery. In particular, any surcharge imposed for interstate access reform should not in any way limit funds otherwise available to achieve the universal service objectives of § 254.

IV. AT LEAST SOME INCREASE IN THE AMOUNT OF FEDERAL SUPPORT IS REQUIRED BY THE ACT.

Ameritech's comments suggest that an increase in the amount of federal support is not only unwarranted but could inhibit competition. Ameritech states that "creating a larger federal fund could have the effect of encouraging states not to adequately address intrastate support issues." Similarly, the Maryland PSC suggests that a new federal fund be capped at the current level of interstate subsidy. AT&T also suggests that federal support should not "increase more than is necessary to replace the federal support that is currently implicit."

The Commission should not adopt Ameritech's conclusion that a federal plan is sufficient so long as telephone penetration remains as high as it was at divestiture. While penetration is certainly the touchstone of any universal service program, other criteria need to be considered. Regardless of penetration levels, the Commission should not overlook the Act's demands that rates remain affordable and comparable.

While the Ad Hoc Plan was designed with the explicit goal of keeping federal support as small as possible, while still sufficient to meet the statutory objectives, the Commission should not be lured into the belief that the existing level of support is adequate.

The existing system has serious gaps that prevent rates in some areas from being reasonably comparable to urban rates. The existing loop support system and the existing DEM weighting system principally support only small companies. High cost companies with more than 200,000 lines receive only a fraction of the support given to smaller companies. Moreover, the DEM weighting program provides no incremental switching support to companies with more than 50,000 customers, but it provides federal support of as much as 85% of switching cost to very small companies. As a result, where large companies happen to serve high-cost areas, the Commission's existing programs provide little or no support. Rates in these areas are high, and are not comparable to urban rates.

Those who suggest that federal support need not be increased at all need to demonstrate that the existing level of support is capable of meeting the statutory standards of affordable and reasonably comparable rates. No such demonstration has been made.

AT&T presents a variation on the theme that no additional funds are needed. AT&T argues that since many large LECS receive more local service revenues than AT&T's preferred forward-looking plan concludes is necessary, these companies do not need any federal support.

This argument ignores the comparability standard in under Section 254(b) of the Act. It is quite possible for a carrier to receive significant local revenues at the same time that its customers are paying rates that are far above "reasonably comparable" levels.

In any case, the difference between the level of revenues received and the level of forward-looking costs (however calculated) is likely to be a reflection, at least in part, of state regulatory treatment of embedded costs. Any attempt by the Commission to calculate federal high cost fund support based on a state's treatment of such embedded costs would likely give rise to thorny jurisdictional disputes. the Ad Hoc Plan, by focusing on genuine and demonstrable differences in *costs* among the states, avoids such intrusions into state regulation.

AT&T also comments that increasing federal support to incumbent LECs that are presently earning significant revenues would be a windfall. AT&T cites a letter from James B. Ramsay of NARUC stating that state commission staff members oppose company windfalls. AT&T misinterprets the NARUC statement. As the term "windfall" was developed at state staff meetings in Austin, Texas, it was intended to mean not merely an increase in support, but an increase that could not, for reasons of state law, be matched with an immediate rate decrease. In other words, an increase in support to a carrier is not a "windfall" if it is promptly passed through to customers. We agree that the Commission should not create windfalls for carriers, but this does not mean that support cannot increase.

V. STATES MUST INEVITABLY PLAY A MAJOR ROLE IN PROTECTING UNIVERSAL SERVICE, AND DEFINING FEDERAL SUPPORT BY AVERAGE STATE COSTS IS A REASONABLE APPLICATION OF SECTION 254.

Several commenters, including the Ohio and Texas Commissions, the Small Western LECs, GTE and US West, argue that similarly situated high cost geographic areas in different states should receive similar amounts of high cost support. For that reason, they object to the state-wide averaging of costs feature in the Ad Hoc Plan. In essence, these commenters argue that the Commission must provide support in high-cost areas without considering the ability of the state to fund its own high cost and rural needs.

The commenters fail to appreciate the fundamental change that the Telecommunications

Act of 1996 makes to the funding of universal service. The Act makes two important changes, and the effect is to make state commissions essential partners in protecting universal service.

First, the Act establishes local exchange competition as the law of the land. Where an incumbent LEC has average prices over its study area, the Act creates conditions that will increasingly challenge that rate design. In a competitive market, LECs will have decreasing ability to maintain implicit subsidies (although they will retain at least some ability to allocate joint and common costs). In a perfect market, prices are driven to cost. Accordingly, the rate averaging and service-to-service subsidies that characterize some existing state rate designs will come under increasing pressure.

At the same time, the Act provides new methods for financing universal service. The Act mandates a federal program and also authorizes state universal service funds.

The combined effect of these two changes is to enlarge the relevant scale of support and transfers. Current implicit transfers operating on the study area level will gradually be replaced by explicit transfers operating on the state level.

But how should state and federal responsibilities be allocated? The commenters are correct in pointing out that the Act does not explicitly create any duty on state commissions to establish universal service funds. Indeed, the only express obligation in the Act is placed on the Commission. In the ideal, perhaps, the federal government could be expected to address all financial problems of the states.

The reality, however, is that the task is so large that the state and federal governments must work together. It is simply not reasonable to expect that the Commission will be able to establish, or Congress would tolerate, an $8 billion federal fund. If the problem is truly of this magnitude, then it can be addressed only by a joint program. Moreover, a joint program offers significant benefits, particularly if the states are assigned roles consistent with their other duties.

The Ad Hoc Plan divides the $8 billion universal service problem into two components. One component, the smaller one, deals with state-to-state differences. Costs in some states are so high that they cannot be effectively addressed by state action alone. The Ad Hoc Plan allocates this problem to the Commission because only a federal program can hope to address it. In a nutshell, the Commission's responsibility under the Ad Hoc Plan is to bring each state to the same starting point. Thereafter, the Ad Hoc Plan leaves the remainder of the problem for the states to solve. This is appropriate since much of the $8 billion cost predicted by the proxy models is presently financed by a variety of implicit transfers now generally found in state rates.

Consider a state in which 90% of the customers are served by an RBOC with price averaging. Through averaging, the RBOC may today be financing the great majority of the needs of its high-cost areas. It should not be surprising to suggest that, since the Act weakens this intrastate system of rate averaging within study areas, it should be replaced by another intrastate system of explicit subsidies within states, under Section 254(f). Therefore it is reasonable to interpret Section 254 to require that federal support be aimed primarily at states that are fiscally unable to provide affordable and comparable rates through their own efforts.

The Ad Hoc Plan, while assigning some responsibility to the states, also gives appropriate deference to state commissions and should improve the ability of states to coordinate the many complex policy issues presented by the 1996 Act. Under the Act, states retain primarily responsibility to set intrastate rates, both for retail services and for UNEs. Under the Ad Hoc Plan, states would also have primary responsibility to determine the extent to which implicit area-to-area transfers or implicit service-to-service transfers should be replaced by explicit subsidies.[2]

A principal result of this division of labor is that the amount of federal support required by the Ad Hoc Plan is considerably less than the amount required by the proxy models when support is calculated at the census block group (CBG) or exchange basis.

While it may be appealing to some states to imagine the Commission providing their customers with a massive increase in federal funding, significant federal benefits channeled directly to LECs may present problems for a state as well. It might be difficult, for example, for a state to coordinate pricing policy if a carrier is receiving $150 per month in federal support for a high-cost area but the state allows UNEs to be purchased in the same area for $20.

Under the Ad Hoc Plan, states would submit a plan that will ensure federal funds are used to establish comparable rates within the state. If costs vary between different areas of the state, that state plan will need to distribute federal funds to areas which have higher costs. If rates in a state are averaged, the total of the federal support plus the implicit support received through

2. Comments from South Dakota claim that the use of state-wide cost averaging continues the implicit subsidy of rate averaging. This is not correct. The Ad Hoc Plan uses cost averaging in order to determine the amount of federal support needed by each state. Once any federal support has been received, state commissions are free, in both high and low cost states, to apply that federal support, supplemented by any state-generated support, from low-cost areas to high-cost areas. This leaves the state commissions free to make subsidies as explicit and rates as deaveraged as they choose.

rate averaging in the state will be similar to the total support received by a similar cost area in another state. If rates are de-averaged, and state support is explicit, the total federal and state support should be similar to the total support (federal plus state provided explicit or implicit support) provided a similarly situated area in another state.

The Ad Hoc Plan would allow all states to immediately achieve rates that are reasonably comparable to urban rates. Moreover, as competition places increasing pressure on implicit transfers, state commissions will be best positioned -- and enough support will be available -- to make those transfers explicit. States that have low average costs will be able to maintain comparable rates even in their extremely high cost CBGs, without any federal funding. Conversely, states with high average costs will receive federal support.

Another advantage of the Ad Hoc Plan is that aveaged state data is more reliable. Concerns over reliability of the data gave rise to Bell Atlantic's proposal, which also utilizes state averaging. Like the Bell Atlantic proposal, the Ad Hoc Plan does not require a calculation consisting of estimating the absolute costs for individual customers, subtracting a benchmark, and then summing the results at the wire center, exchange, or CBG level. Rather, the Ad Hoc Plan calculates state average costs, in comparison to national average costs. The Ad Hoc Plan thus uses proxy models only to determine the *relative* level of cost difference from one state to another. This will tend to cancel cost distortions that might appear at smaller scales.

The Ohio Commission is concerned that the fact that Ohio is a low cost state virtually guarantees it will not receive any additional high cost funding. This, however, is not a valid objection to the plan. States with low average costs, such as Ohio, by definition have the ability to subsidize small companies with explicit state support and still keep their rates comparable with other states. Ohio has low rates and large calling areas in Cleveland, Columbus and Toledo. A very small surcharge in Ohio's low-cost areas will provide more than sufficient explicit support for Ohio's few high cost lines. Ohio does not need federal support to keep its rural rates comparable.

VI. THE AD HOC PLAN IS FAIR TO STATES WITH VERY HIGH COST AREAS.

South Dakota's comments claim that the Ad Hoc Plan is detrimental to states with extremely high cost loops, but favors states with moderately high cost loops. This is incorrect. The plan does favor some states with significant numbers of moderately high cost loops. These states include, among others, Maine, Vermont and West Virginia, which have high average costs primarily because of the balance between the numbers of high cost and low cost loops. However, it is also true that some other states that benefit from the Ad Hoc Plan, including Montana and Wyoming, have a comparatively high proportion of extremely high-cost loops.

South Dakota's comments appear to disagree with an essential element of the Ad Hoc Plan, that states with low average cost can afford to support their own high cost loops without federal help. It is true that the Ad Hoc Plan does not favor low-cost states, even some that have some extremely high-cost areas, such as Texas, Colorado, California and South Dakota. The Ad Hoc Plan denies support to these states because they have the ability to fund their high-cost areas with explicit subsidies from their relatively large low-cost areas. The Ad Hoc Plan appropriately targets funding to states that would be unable to set comparable rates without sufficient federal support.

VII. THE AD HOC PLAN IS FAIR TO SMALL COMPANIES.

South Dakota commented that cost averaging will not provide sufficient support to small companies if the state in which the company is located has low average cost. To address this concern, the Ad Hoc Plan includes a generous hold-harmless provision.[3]

If a small company in a low-cost state needs support not presently offered by the Commission's various support systems, the Ad Hoc Plan would requires states like South Dakota to generate internally some support that would be needed to keep rates comparable in those areas. Low cost states have the ability to do this and still keep their rates comparable.

3. Contrary to South Dakota's assertion, purchasers of U S West exchanges will not be unfairly deprived of support. The hold-harmless calculation under the Ad Hoc Plan is recalculated each year based upon current data, as though the existing system had remained in effect. Thus small companies that have purchased U S West exchanges will experience a step-up in their hold harmless protection as the new embedded cost data are incorporated each year, just as they would under the current system..

VIII. THE 25-75 SPLIT OF HIGH COST RESPONSIBILITY IS NOT SUFFICIENT.

Comments by Ameritech suggest that the 25-75 split described in the Commissions order of May 8, 1997 meets's the eight principles identified by Chairman Kennard. To the contrary, the 25-75 split violates the Act.

Where a carrier receives federal support in an amount less than the difference between its costs and the national benchmark price (or national average cost), it will have to make up the difference by charging more than a carrier with costs near the national average cost, thereby defeating the goal of reasonably comparable and affordable rates. In setting support at 25% of the USF need, the Commission's 1997 Order leaves a very large difference to be made up.

The surcharge level needed to fund the remaining 75% of the universal support need depends primarily on three factors:

- The number of customers in high cost areas and the average level of support they require;
- The number of citizens in low cost areas who can contribute to a state's universal service program while maintaining affordable rates; and
- The proportion of interstate to intrastate calls made by customers in the state. Because the Federal fund will be a first assessment on interstate revenues, state funds are confined to a "first" assessment on intrastate revenues and a secondary assessment on interstate revenues.[4] States with a high percentage of intrastate calls, generally larger states, may be able to raise the necessary revenue with a lower surcharge.

The states vary greatly in all of these factors. Terrain and demographics certainly vary and costs vary with them. A significant number of states have not a single major low cost city to support rural residents within the State. Largely because of variance in population, states range from 40% to 66% in the percent of revenue derived from intrastate calls.

Using the approach in the May 8 order and the HAI model, the total national need for support would be $4.96 billion per year.[5] If federal funds were to provide 25% of the support needed, the remaining 75% would fall to the states. The size of that burden varies dramatically

4. In addition, some states may lack jurisdiction under state law to assess interstate revenues to develop their own state fund.

5. This assumes that support will be calculated by the HAI model, run on a density zone basis.

from state to state. For example, North Dakota would need to raise and distribute $20.82 per line per month to reach full support.[6] To raise this much money, North Dakota would need to impose a surcharge of 30% on its carriers' intrastate revenues.[7] Montana and South Dakota also would need to impose rates of 30% or more. Such high surcharges will threaten achievement of the goals of reasonably comparable and affordable rates set by Sections 254(b) and (e) of the Act.

IX. RAISING THE BENCHMARK IS NOT SUFFICIENT.

It is no answer to suggest, as do the California PUC [8] and U S West, that the "benchmark" can be raised so that the national fund size is reduced to a politically sustainable level. Raising the benchmark to $50 or higher will indeed reduce the size of the federal fund, but it will not comply with the Act. Proponents of a "super-benchmark" need to demonstrate, as they have not, that the support levels they propose will produce reasonably comparable rates in all rural, insular and high-cost areas.

The weakness of this method can be seen by taking it to an extreme. If the benchmark were raised high enough, federal support would be provided only to customers in the one CBG in the U.S. that happens to have the highest cost. Such a program could be funded easily, but it would be clearly inadequate under the Act. Even in the one CBG that receives support, the high benchmark would ensure that support is not sufficient. In other CBGs having very high cost lower than the benchmark, no support would be received at all. This could not satisfy the Act's requirements that rates in all rural, insular and high-cost areas be reasonably comparable to urban rates.

Even at a less extreme "super-benchmark," say $50, rates would violate the Act. Since support would go to high cost CBGs everywhere, some support would be received in states with low rates and costs, based upon even a small proportion of customers located in very high-cost

6. State support per line per month would also exceed $10.00 in Montana, Nebraska, South Dakota, and Wyoming.

7. This assumes intrastate revenues in North Dakota of $333 million per year in 1999. Part of this may be implicit in rates already.

8. Comments of California PUC at 2 (federal support should be targeted to exceptionally high-cost areas).

areas. Some of this federal support would, no doubt, supplant existing intrastate implicit transfers. The result could be that federal support would actually further reduce the existing low rates. This would not be an efficient use of the available resources.

For example, if the U S West plan were adopted, SBC in California would receive significant additional support. Much of this money would be new money, and could reduce rates for SBC customers in California. However, it is not clear why SBC's California customers need any additional support. According to data published by the Commission, local rates for SBC's California customers are already among the lowest in the country.[9] It makes little sense to increase federal support for SBC in California because it has some high cost customers, when the effect of that support could actually be to lower SBC's already low urban rates.

Conversely, in states with uniformly high cost and high rates, a high benchmark could result in minimal federal support, or no support at all. Even if a state universal service fund were in place, the result would be the continuation of high rates that are not reasonably comparable to urban rates.

Although raising the benchmark is not, by itself, an answer, it can nevertheless work in conjunction with the Ad Hoc Plan. A "super-benchmark" feature, providing 100% federal support above a certain level, could be melded with the Ad Hoc Plan. The Commission might, for example, declare that these areas have costs so high that it is a federal responsibility. Below this super-benchmark, however, the Commission would consider a state's ability to support its own high-cost areas, as envisioned in the Ad Hoc Plan.

9. The Commission publishes data on rates for a private line with unlimited calling, touch tone charges, SLCs, surcharges, and taxes in 95 cities for 1995. The data show rates for 11 California cities. Of these, 9 are SBC (formerly Pacific Telesis) cities. Rates in all nine California cities are under $17.00 per month. The By contrast, six cities in the list have rates in excess of $25.00, and Burlington, Vermont would be in this latter group if it were included in the list of cities reported. FCC Industry Analysis Division, *Reference Book of Rates Price Indices and Household Expenditures for Telephone Service*, March 1997,

X. FORWARD-LOOKING COSTS AND EMBEDDED COSTS SHOULD BOTH BE USED IN CALCULATING SUPPORT.

Several parties commented on the use of embedded costs in the Ad Hoc Plan. Some parties, such as the South Dakota and California PUCs, argue that federal distributions should be based only upon forward-looking models. Others, such as Bell Atlantic, take the contrary view and suggest that forward-looking models are flawed and produce "wildly inconsistent" results.

South Dakota and California oppose the use by the Ad Hoc Plan of embedded costs as a factor to determine and limit the level of USF funds available to each state. South Dakota goes on to state that the use of embedded cost will not provide sufficient support so that rural areas can have both comparable rates and service as required by the Act.[10]

Embedded cost can be appropriately employed in federal high cost distributions for a variety of reasons:

- embedded cost can provide a check on extreme values produced in some cases by proxy models;
- embedded cost promotes efficiency by limiting support payments where initial investment is low or depreciation reserve is high; and
- embedded cost creates an incentive in areas with inadequate service to actually upgrade service.

South Dakota also states that the use of embedded cost penalizes states with old plant and high depreciation rates. Any such effect, however, is accomplished in a manner consistent with the objectives of the Act. Under the Ad Hoc Plan, embedded cost determines support for some

10. South Dakota commented that it disagrees with the Ad Hoc Plan's equal treatment of large and small companies. It states that this proposal ignores the "economy of scale" of large companies. In fact, however, the Ad Hoc Plan, coupled with an adequate cost model, will account for any economies of scale that actually exist. The use of embedded cost by definition reflects economies of scale. With proper inputs, the forward looking cost models should also recognize those economies. Although the Ad Hoc Plan proposes one scheme for all companies, its proponents recognize that cost studies for rural areas may need more refinement than those for urban areas. This suggests added caution before relying totally on forward-looking costs for rural areas, including those rural areas served by large companies.

states, particularly those with highly depreciated plant.[11] This feature provides a significant incentive for network upgrades since a carrier in that state will receive more support as soon as new investment is made or committed. This creates a significant incentive for investment in areas that have highly depreciated plant.

By contrast, if federal support were based solely on forward-looking cost, carriers may have little or no incentive for investment. Federal support would flow whether upgrades occur or not. If the Commission is concerned that carriers should have meaningful incentives to upgrade old plant, it will not want to use forward-looking costs to calculate support. A support system that rewards additional investment would be much more likely to induce network improvements.

Sprint also criticizes the use of embedded costs in the Ad Hoc Plan as inhibiting competition. Sprint notes that competitors do not face embedded costs, but forward-looking costs, and that if competition is to emerge, the market must "send the correct economic signals." This concern is misplaced. In a competitive market a new entrant will face an incumbent whose rates are based on embedded costs. If the CLEC's costs for constructing new facilities are higher than those of the incumbent, it will not survive in that market regardless of how the Commission distributes high cost support. Moreover, support will be competitively neutral and available to all carriers. As Sprint notes, this support may just meet the forward-looking costs of the CLEC. The same level of support, however, will exceed the incumbent's costs, and this can *harm* competition. The incumbent will receive a cash surplus that could be used as a war chest to fight competitors. An incumbent company might, for example, apply the new federal support to reduce prices below incremental cost in a competitive urban territory, and leave rates high in its noncompetitive high-cost areas.

Comments by TDS note that if forward-looking costs understate the cost of providing service, then support may not be sufficient. The Ad Hoc Plan recognizes this concern through inclusion of the hold harmless mechanism, which is based on historic costs.

Some commenters (e.g., S.W. Bell, TDS, Bell Atlantic, Rural Coalition) either challenge entirely any use of forward-looking models or they recommend delay in their use (at least for rural

11. The Ad Hoc Plan suggests use of projected or committed investment as the basis for calculating support. This will provide a flow of funds for that new or upgraded plant as soon as the revenue requirement for it exists.

companies) until the models produce reliable results. If the Commission shares this concern, it might choose to delay the use of forward-looking models until a reliable proxy model can gain credibility and the effects on high cost support can be analyzed. In that event, the Commission should modify the existing loop support system, which is based solely upon embedded costs. At a minimum, the existing system should be modified to include loop, switching and trunking costs.

Bell Atlantic also proposed to modify the Ad Hoc Plan by mixing various measures of forward-looking and embedded cost. This may also be viable as an interim option. However, averaging forward looking and embedded costs undermines the theoretical basis for the Ad Hoc Plan's use of the lesser of embedded or forward looking cost. We continue to believe that the lesser of forward-looking and embedded cost is the appropriate basis for constructing high cost support.

XI. IT IS APPROPRIATE TO USE COST RATHER THAN REVENUE BENCHMARKS

CompTel and AT&T criticize the use by the Ad Hoc Plan of a cost benchmark rather than rate or revenue benchmark. They state that the use of a cost based benchmark does not reflect revenue already available to a carrier to cover its costs. As stated in the Ad Hoc Plan, however, rates (or revenues) do not provide a uniform standard by which the cost of telephone service can be compared. For example, the local rate in Denver or Atlanta may provide local calling 30 to 40 miles in all directions while the local rate in a small Maine town may include only 500 lines, all within a few miles of each other. Local rate level differences between states may also reflect access charge and toll rate pricing policies more than cost differences. The Ad Hoc Plan compares average state cost and the national average cost in order to determine the need for federal support to that state. The use of rates rather than cost for this purpose would encourage states to increase their rates to maximize service support. By using a comparison of average costs in each state with national average costs, the ad hoc approach also avoids the problem identified by CompTel and AT&T of the so-called "additional revenues," because those revenues are removed from <u>both</u> averages.

XII. THE AD HOC PLAN IS COMPETITIVELY NEUTRAL AND IS COMPATIBLE WITH COMPETITION.

Comments by ALTS characterize the Ad Hoc Plan as anti-competitive and states that the plan provides a preference to incumbent LECs. ALTS does not appear to understand the proposal. The Ad Hoc Plan requires the states to submit plans that ensure comparable rates and which are competitively neutral. A state plan that provides a preference for the incumbent will not meet that standard. The proponents of the Ad Hoc Plan envision that a competitively neutral plan will require that the support given to any geographic service area be reduced to a per line amount and provided to the carrier actually providing the service to the customer.

MCI expressed a concern that Ad Hoc Plan's use of updated embedded costs will allow unlimited uneconomic investment or excess capacity to be paid for by the fund. MCI's fears are groundless. Under the Ad Hoc Plan, the fund is limited by the lesser of embedded or forward looking costs. Thus, a carrier will still be limited by the forward looking cost ceiling no matter how much investment it makes in any given area.

South Dakota incorrectly claims that using embedded cost violates the principle of competitive neutrality. The principle of competitive neutrality applies to the manner in which funds are collected and distributed; it does not apply to the manner by which support is determined. So long as the equal funds are provided to all LECs serving the same area, the Ad Hoc Plan remains competitively neutral.

XIII. STATE DISTRIBUTION OF FEDERAL FUNDS DOES NOT UNDERMINE THE ACT.

Sprint commented that state distribution of federal support would not fulfill the purposes of the Act because state commissions would have unlimited discretion over the distribution of the funds. In fact, the Ad Hoc Plan would not allow a state unlimited discretion to distribute funds wherever it sees fit. A state plan must be submitted for approval to the Commission and must meet the goal of achieving comparable rates. That plan must distribute funds to carriers serving customers in high-cost areas. The plan must also be competitively neutral, and in any given area, the state must provide equal support to ILEC and CLEC alike. It is difficult to see how this would amount to "divert(ing) the monies" from universal service.

None of the objections voiced to the Ad Hoc Plan provides a reason to reject the plan. The Ad Hoc Plan remains the only model that complies fully with the Act and has the support of state commissions in both high cost and low cost areas. The Commission should move forward with its review of the Ad Hoc Plan and implement that plan or one similar to it by the end of this year.

Submitted this 29th day of May, 1998 on behalf of the following.

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I, Thomasine Butler certify that on this 29th day of May, 1998, I served "Reply Comments on Proposals to Revise the Methodology for Determining Universal Service Support" on the parties listed on the attached service list by first class postage paid mail. The Federal Communications Commission officials and staff were served by hand delivery to The Federal Communications Commission.

Thomasine L Butler

Thomasine Butler

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